

February 21, 2012

from  Montage Investments

President Obama's Budget Proposes Capping Deductibility of Tax-Exempt Interest

President Obama's Fiscal 2013 budget proposal, released on February 13, contained an unwelcome Valentine's Day gift for the municipal market. The budget reintroduces a proposal to cap the value of tax preferences at 28%, including tax-exempt interest earned on municipal bonds. If approved, the measure would mean that investors in tax brackets higher than 28% would have to pay income taxes on municipal bond interest at a marginal rate equal to their tax bracket minus 28%. For an investor in the 35% federal tax bracket, this means that municipal bond interest would be taxed at an effective rate of 7%.

The 28% cap proposal was originally introduced last September as part of the President's proposed American Jobs Act. While that bill failed to advance in Congress, it put on the table the possibility that municipal interest could be a target for administration budget writers. The administration projects that the cap, which would apply to single taxpayers with income greater than \$200,000 and joint filers with income greater than \$250,000 and would go into effect on Jan. 1, 2013, would generate \$584 billion of additional federal revenue (aka, "deficit reduction") over 10 years.

The inclusion of the 28% cap came as somewhat of a surprise to many in the municipal marketplace, as White House economic advisors had signaled to state and local government officials as recently as late January that the municipal interest provision would not be included in the FY2013 budget. A wide variety of governmental organizations and municipal market groups pushed hard against the original proposal last fall and are again organizing to oppose the cap provision in the budget.

We do not believe that the 28% cap provision is likely to survive in the budget. The municipal market has not shown any meaningful reaction to the budget proposal this week, either in trading activity or yield levels. Furthermore, we are already seeing reports of strong opposition to this provision on the part of members of Congress, the financial services industry and state and local governments. We will continue to closely follow the budget's progress and analyze the potential impacts on municipal bonds, though at this time we do not recommend that investors take any action to reduce holdings in municipal bonds as a result of this budget proposal.

Potential Impacts of the 28% Cap

If passed, the cap would have an impact both on new issue municipal bonds and on the value of outstanding municipal bonds already held by investors. Issuers of new municipal bonds would have to pay higher yields to investors to compensate for the loss of tax-exempt interest above the 28% cap. Existing holders of municipal bonds would see the value of those holdings decrease, as the value of the existing interest payments was eroded by income taxes now levied on some portion of that income.

As we discussed in September 2011, a Citigroup analysis of the impact of a 28% tax preference cap suggests that the yield effect of the change for taxpayers in the 35% bracket holding a muni yielding 4% would be to reduce returns by approximately 28 basis points ('bps', or 0.28%) on a nominal basis and approximately 60 bps on a taxable equivalent basis. Any future changes to tax brackets that increased marginal tax rates would make the yield effects even more pronounced.

According to IRS data from 2009, as much as 58% of the tax-exempt interest reported was from individuals with incomes greater than \$200,000. Consequently, the effects of this proposal would be felt very broadly in the municipal market. The repricing of bonds that resulted could potentially wipe out billions of dollars of investor wealth currently held in individual portfolios and in municipal bond funds.

For issuers, published reports that we have reviewed suggest that in order to bring after-tax investment yields back in line with current market levels, issuers would have to pay yields of 40bps to 50bps higher on their bond issuances to attract investors under the new tax treatment. Depending on the level of issuance in the market, the resulting cost to issuers of such an increase in market yield could be on the order of \$10 billion of additional interest payments. Such an increase in borrowing costs would likely make some capital projects uneconomical for state and local issuers. The Obama Administration is seeking to offset the impact of higher borrowing costs by reintroducing Build America Bonds (BABs) in the FY 2013 budget. We will discuss this provision in more detail in the future if it appears to have traction, but at the currently proposed 28% subsidy rate, new BABs would likely be far less attractive to issuers than the original program with its 35% interest rate subsidy for issuers.



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COMM-AIP-021712